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CENTRAL INTELLIGENCE AGENCY
WASHINGTON, D.C. 20505

CIA/OER/S-06783-75 [redacted]

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14 February 1975

MEMORANDUM FOR: Mr. David Laux
Office of National
Security Affairs
Department of the Treasury

SUBJECT : South Korean Economy

In response to your 13 February request we are forwarding the attached report on the South Korean economy for use by Secretary Simon in preparing for his Tuesday meeting with Korea's Deputy Prime Minister. As the report indicates, Korea has been hard hit by the world-wide economic downturn and subsequent fall-off in foreign demand for Korean goods. While real growth has been practically halted, the trade and current account deficit has swelled. A key reason for the Nam Duk-wu visit is to help arrange financing from US sources. If there is any further information required on this or related subjects, we will be happy to oblige.

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Chief, Japan/Pacific Branch
Industrial Nations Division
Office of Economic Research

Attachment:
As stated

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THE SOUTH KOREAN ECONOMY

1. South Korea's economy has been hard hit by the world-wide economic slump. Although real growth last year averaged around 8%, all the gain came in the first half. The downturn will extend well into 1975 when real growth will probably register only slight gains. Seoul will be unable to achieve anything near its goal of 7% real growth this year because of continued weak demand in major industrial countries which take the bulk of Korea's exports. The payments deficit, after bulging last year, will remain large in 1975.

The Domestic Scene

2. Real output, after increasing sharply during the first half of 1974, stagnated during the second half. Foreign demand, absorbing roughly half Korea's goods production, has weakened sharply, especially in Japan and the United States, and prospects for recovery are poor at least through mid-1975. The falloff in foreign demand is already forcing sharp cutbacks in industrial output. By October, output was running roughly 10% below the early 1974 peak. Evidence suggests that production has declined further in the past several months.

3. The downturn has spread to nearly all industries. The hardest hit include textiles, plywood, electronics and other light consumer manufacturers that export the bulk of their output. At the end of last year, output in the important textile industry, for example, was down 20% from the early 1974 peak, the sharpest decline in years. Heavy industry continued to do relatively well into the third quarter, but also turned down toward the end of the year.

4. Unemployment has risen substantially. Layoffs last year totaled at least 100,000 factory workers, roughly 2% of the labor force. Several major US and Japanese firms in Korea have initiated substantial layoffs. Most foreign and locally owned firms, however, are maintaining their labor force, preferring instead to reduce work hours when necessary. Nonetheless, employer groups and the government are concerned over the likelihood of increased labor unrest, particularly in urban areas.

Government Policies

5. Seoul's primary economic objective has shifted from controlling inflation to maintaining employment and output. To accomplish this the government reversed its fiscal policy in the fourth quarter of last year. The budget - in surplus during the first 10 months of 1974 -- is now running a deficit. Seoul is increasing spending on public works, welfare, defense, agricultural development and government industrial projects. The public works program is essentially aimed at offsetting the decline in private sector employment. Seoul is also providing special loans from budgeted funds and government-owned banks to private businessmen to help avoid a rash of bankruptcies.

6. Seoul also announced an 17% devaluation of the won on 7 December to stimulate exports and dampen imports. To help offset the inflationary impact of devaluation, Seoul has tightened its monetary policy somewhat by raising reserve requirements and interest rates. The government is also controlling price increases on 58 key commodities, although it has adjusted petroleum products prices and electricity rates by 31% and 42%, respectively, to reflect increased oil prices and the won devaluation.

7. Despite monetary tightening, inflation shows no sign of easing. Consumer prices in December were about 30% above last year's level, while wholesale prices were up 45%. The won devaluation and energy-related price adjustments boosted wholesale prices nearly 6% in December alone. Nevertheless, Seoul hopes to hold overall inflation this year to around 20% -- last year's rate was 30%. This may prove difficult, however, because of pressures for large catch-up wage hikes and the likelihood of small productivity gains.

Trade and Payments

8. Higher oil and other commodity prices boosted Korea's trade deficit sharply in 1974 to $1.7 billion. Export value rose 40%, imports were up 60%; both increases primarily reflected higher prices. The current account deficit was about $1.8 billion compared with $300 million in 1973. Half of the deficit was offset by long-term capital inflows stemming in part from investment commitments made in 1973. Short-term borrowing abroad also increased sharply, with net inflows totaling nearly $800 million.

9. The trade and current account deficits in 1975 will approximate $2 billion. Export growth will slow sharply from last year's rate because of continuing weak foreign demand. Although Seoul is projecting a 33% rise in overseas sales, the increase will probably be less than half that rate. Imports will increase moderately because of higher average oil prices. Neither export nor import value will grow significantly. Net service payments will increase only slightly, amounting to between $100 million and $200 million.

10. Seoul plans to finance its current deficit by increasing long-term foreign borrowing. Korea will probably seek between $1.5 billion and $2 billion in net long-term foreign capital this year, up from $1.2 billion in 1974. Negotiations are underway to borrow some $200-$300 million from Middle Eastern oil exporting countries, and $200 million is being sought from the IMF under an expanded oil facility. Another $1.3 billion in long-term funds will be sought from international lending institutions, as well as the United States, Japan, Canada, and West European countries. Included in this total is a $200 million loan now being arranged by a syndicate of US banks.

11. Korea hopes to obtain enough long-term funds to avoid any drawdown in foreign exchange holdings, which came under heavy pressure last year. Seoul's holdings now total roughly $1 billion, or less than two months' worth of imports. The immediate impact of increased foreign borrowing on Korea's foreign debt service burden is not serious. The debt service ratio is likely to rise from last year's 12% to about 14%. Seoul's good international credit rating will probably enable Korea to obtain most of the funds it expects to need. Emergency financing would be needed later in 1975 if the trade situation proves worse than we now foresee. Under these circumstances Seoul would seek additional assistance from the United States which it views as a lender of last resort.

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